Insight INVESTMENT

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OPPORTUNITIES FOR RETURN IN LESS LIQUID CREDIT

WE BELIEVE THERE IS AN ATTRACTIVE INVESTMENT OPPORTUNITY IN SECURED FINANCE MARKETS FOR INVESTORS LOOKING TO ACHIEVE HIGHER LEVELS OF RETURN.

Secured finance opportunities arise from the process of disintermediation in the lending market away from traditional banks, as well as from the continually increasing regulatory pressure on banks to 'clean-up' their balance sheets and increase the amount of capital they hold against their lending activities.

Furthermore, the potential returns from more crowded lending markets, such as direct lending, are shrinking and we believe that there are attractive opportunities for investors to exploit the complexity and illiquidity premia available in growing segments of the secured finance market such as: speciality finance, non-performing loans and regulatory capital transactions.

SPECIALTY FINANCE

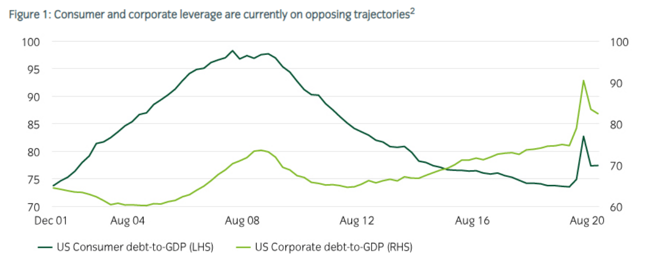
Specialty finance refers to the emergence of non-bank lending "platforms", which often started as peer-to-peer lending platforms (or "fin-tech" companies). Many of these platforms were successful but found that their growth was constrained by the availability of peer capital rather than by the demand for loans. In order to continue to grow they diversified their sources of funding and evolved into "investor-to-peer" platforms.

The more successful of these specialty finance companies are increasingly shifting towards the securitisation market for funding. Potential lenders are able to assess a large number of borrowers and can invest in the better-quality opportunities; benefitting from the traditional banks focus on "plain vanilla" lending using more traditional (and some would argue antiquated) lending practices.

Many investors have focused on direct lending opportunities to access this trend and we have seen a record amount of funds raised in this segment of the market over the last couple of years. However, this competition has driven potential returns from direct lending opportunities significantly lower, whereas the consumer sector, by contrast, has received less interest, and, in our view, offers compelling opportunities.

From a credit risk perspective, investments within the consumer space should also benefit from strongly diverging trends in leverage; the consumer has been on a deleveraging trend since the Global Financial Crisis in 2008 (apart from a short-term pandemic induced spike in 2020), while corporate leverage has been on an upward trajectory (see Figure 1) given the low cost of issuing debt and demand for increased share buybacks and M&A activity.

Table 1: Consumer and corporate leverage are currently on opposing trajectories



This investment opportunity has been broadened as a result of the pandemic as bank lending remains insufficient to meet the strong and persistent level of demand from borrowers underserved by traditional banks. The response by policymakers (such as loan guarantees and employment support schemes) are also supporting the sector.

Investors can provide capital to these speciality lenders in return for attractive levels of return. Investors have access to the underlying loan pool information and can assess the credit risk in the same way they would any pool of consumer or SME loans within a traditional asset-backed security. The speciality finance companies are usually looking for strategic partners, ideally those without a conflict of interest, in other words, long-term, institutional non-bank investors.

NON-PERFORMING LOANS

Traditional European banks have been under pressure by regulators to "clean up" their balance sheets. A key part of this is the disposal of non-performing loans (NPLs) to a third party. These loans are sold at a significant discount reflecting the real value. This disposal of NPLs by European banks began in the more developed markets (such as Ireland) and spread to the peripheral European markets such as Spain and Italy and still continues in Greece and Cyprus.

There are a number of reasons why this selling activity has picked up in momentum since 2016 onwards and has spread across more jurisdictions. Firstly, broad regulatory changes as well as the European Central Bank increasing the pressure on banks to clean up their balance sheets and start lending again to help the recovery after the European crises, and the pandemic more recently. Secondly, many of the longer-term NPLs (from 2008) have recovered in value, which has allowed the banks to realise the losses on those loans and sell them to a third party (still at a discount to their original value, but albeit smaller). Lastly, many countries have enacted new legislation (such as Italy and Greece) to facilitate the disposal of NPLs by banks to non-bank investors.

These three factors have created substantial opportunities to acquire portfolios of NPLs from the traditional banking sector. At present this opportunity is largely restricted to European NPLs, although this may change over time.

REGULATORY CAPITAL (REGCAP) TRANSACTIONS

The introduction of Basel III has forced banks to meet new and much tougher capital requirements. There are several options open to banks to meet these higher capital needs, including:

- Raising equity in the public market, although many banks remain under pressure to return capital to shareholders via dividends and share buybacks, rather than raising more capital.
- Reducing the size of their balance sheet. This may involve a retrenchment in profitable lending activity or, as noted above, sell some of their non-core of non-performing loans to third parties.
- More efficiently structure their balance sheets to improve their regulatory capital ratios without sacrificing profitable areas of their lending activities. The main mechanism to achieve this is via regulatory capital transactions (also known as significant risk transfer transactions (SRT).

A RegCap transaction is a result of a bank looking to improve its regulatory capital ratios by getting an investor to provide credit protection against part of its loan book in return for a premium. The investor will agree a suitable portfolio of loans on the bank's balance sheet and will provide protection against losses on those loans. This provides the bank with a regulatory capital relief against losses on those loans, that they would otherwise have to hold capital against or provision for.

As well as the capital advantages it also leaves the underlying loans on the bank balance sheet and enable the bank to maintain the corporate relationship (and broader business opportunities) with the end borrowers. As with the NPLs, banks are looking for longer-term, institutional investors to sell these loans to.

From an investors perspective they gain an attractive premium in return for exposure to the credit risk from a diversified portfolio of loans that they have tailored.

CONCLUSION

There is a range of attractive opportunities within the secured finance universe for investors looking to achieve higher levels of return than on offer from either the corporate bond or senior secured finance universe.

By constructing a diversified portfolio in the market segments outlined above, combined with more opportunistic investments in junior tranches of asset-backed securities, we believe that investors can exploit the complexity and illiquidity premia that this asset class delivers, achieving an attractive risk-reward profile when compared to other credit markets, such as corporate bonds or direct lending.

Insight's Secured Finance Team is highly experienced in investing in secured opportunities. To find out more about how Insight can help investors explore these opportunities, please get in touch and we will happily schedule a call.

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees and charges and these can have a material detrimental effect on the performance of an investment.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. Funds which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

Fixed income

- Where the portfolio holds over 35% of its net asset value in securities of one governmental issuer, the value of the portfolio may be profoundly affected if one or more of these issuers fails to meet its obligations or suffers a ratings downgrade.
- A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.
- The issuer of a debt security may not pay income or repay capital to the bondholder when due.
- Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.

- Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.
- Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.
- Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.
- The investment manager may invest in instruments which can be difficult to sell when markets are stressed.
- Where leverage is used as part of the management of the portfolio through the use of swaps and other derivative instruments, this can increase the overall volatility. While leverage presents opportunities for increasing total returns, it has the effect of potentially increasing losses as well. Any event that adversely affects the value of an investment would be magnified to the extent that leverage is employed by the portfolio. Any losses would therefore be greater than if leverage were not employed.
- While efforts will be made to eliminate potential inequalities between shareholders in a pooled fund through the performance fee calculation methodology, there may be occasions where a shareholder may pay a performance fee for which they have not received a commensurate benefit.

FIND OUT MORE

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